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EXECUTIVE SUMMARY OF STUDIES ON MULTIPLE EXCHANGE RATES SYSTEM, DIFFERENTIAL INTEREST RATES POLICY AND PRODUCTION SUBSIDIES

PART I: SUMMARY OF COMMISSIONED PAPERS

Section A - Paper by Melaku Kifle, Ethiopia

The paper analyses issues pertaining to multiple exchange rate systems (MERS) and differentiate interest rates policy (DIRP). In both cases the paper reviews the theoretical basis for the policy instrument, the experiences (in African countries) in applying the policy instruments and the application of the policies in the context of the African Alternative Framework to Structural Adjustment Programmes for Social-Economic Recovery and Transformation.

A.1. Multiple Exchange Rate Systems (MERS)

A.1.1. The Theoretical Basis

In situations of balance of payments disequilibria, there are a number of policy approaches that can be contemplated: reduction in the domestic level of income, changes in interest rates, changes in relative prices or non-market controls.

However, most of these policy choices are also associated with limitations. With respect to devaluation, it is argued that for a country facing given world prices of traded goods, the domestic prices of the traded goods are simply the world prices adjusted for changes in the domestic currency value of foreign exchange. As a result, devaluation has the immediate effect of raising the relative prices of traded to non-traded goods. Secondly, devaluation has effects on the real cost of domestic factors of production and on the real value of given nominal wages. Thirdly, devaluation and the resultant increase in the price level reduces the real value of private sector liquidity unless it is offset by commensurate changes in money supply. Overall, devaluation can be associated with reduced economic growth, increased unemployment, undermining public sector investments and development priorities, increases in the cost of living and distorted income distribution pattern. Indeed, devaluation may have negative effects on the economy without improving the external payments position.

A multiple exchange rate system can be used as a balance of payments instrument as well as to achieve other specific objectives, such as earning revenue, restricting imports and protecting infant industries.
By fixing different rates of exchange for various classes of imports and exports, a country can avoid the negative effects of indiscriminate devaluation. Multiple import rates can be used to minimize an increase in imports, to control imports of luxuries and to favour production inputs. Similarly, multiple export rates can be used to encourage specific export items and to change the export structure. In most cases, multiple exchange rates can minimise inflation (through the sterilisation of exchange profits) and as an alternative to customs duties and taxes. In such cases multiple exchange rates can also be used to reconcile seemingly conflicting objectives, such as controlling inflation and diversification of the economy. However, multiple exchange rate systems also have inherent problems. Some of the most serious limitations of multiple exchange rates include: complexity of administration in terms of changing the rates or

commodities to which different rates are to be applied; the difficulty of determining the appropriate rates so as to avoid the emergence of cross rates; the possibility of reinforcing uneconomic utilisation of scarce domestic resources; the likelihood of engendering corruption and the discriminatory effects among competitors.

A.1.2. Experiences of some African Countries

The application of multiple exchange rate systems is examined for Uganda, Zambia and Nigeria.

In the case of Uganda the principle objectives of the exchange rate policies were to increase production for export, reduce budget deficits, counteract the erosion of the Ugandan currency by high inflation, encourage savings and have efficient allocation of scarce credit. Uganda quotes two separate exchange rates based on an official market and a commercial market with the former being for official transactions, essential imports and specified traditional exports.

In the case of Zambia, a dual exchange rate system was introduced in 1987, comprising an official rate that was to move within a bank and an auction determined rate. The official rate covered government procurement of medicine, education materials, debt service and proceeds from external loans and grants. All other transactions were under the auction rate.

In Nigeria, the overall adjustment package aimed at restructuring the patterns of consumption and production, maintenance of fiscal and balance of payments equilibrium, laying the basis for sustainable and non-inflationary growth and reducing the dominance of the public sector. In 1986 Nigeria introduced the Second-Tier Foreign Exchange Market (SFEM) and the single official market was changed to a Foreign Exchange Market (FEM). This system consisted of a first-tier which was an administered rate covering debt servicing etc. and a second-tier (covering all other transactions) operated through foreign exchange auctioning conducted by the Central Bank and an inter-bank market. These tiers were converged in July 1987 such that only one rate applies.

A.1.3. Multiple Exchange Rate System in the context of AAF-SAP

In the context of AAF-SAP, the paper states that many of the advantages attributed to multiple exchange rate systems have been realised in practice. The system has been effective as a tool to control inflationary presssures through, inter alia, offseting the price and income effects accompanying inflation; holding down a rise in exporters' incomes in periods of export booms and checking increases in key prices in the economy. The system has also been used successfully during a transition from one exchange system to another, especially in situations where devaluation is difficult to effect in one step. Finally, the paper acknowledges that multiple rates exist in many African countries on a de factor basis, as is indeed stated in AAF-SAP.

A.2. Differential Interest Rates Policy (DIRP)

A.2.1. The Theoretical Basis

In the paper it is stated that various theoretical arguments have been advanced regarding the role of interest rates.

In classical analysis the rate of interest is a real variable determined by the real forces of supply of savings and demand for investment with money supply playing a passive role. The Keynesian theory stipulates that the rate of interest is a monetary phenomenon since it is affected by the supply and demand for money. As a policy instrument, interest rate has effects on the rate and pattern of economic growth as it influences the volume and productivity of investments as well as the volume and disposition of savings.

On differential interest rates, the paper argues that in a transitional stage of socialist development, interest rates are differentiated depending upon the degree of socialisation of the various economic sectors. Preferential treatment is given to collective and state sectors against the private sector. Also, to the extent that interest rates serve as instruments to allocate credits, those sectors which contribute to the fulfilment of domestic consumption, or generate higher income, or serve as a source of foreign exchange, etc. can be favoured in terms of interest rates.

A.2.2. Experiences in selected African countries

The paper outlines the experiences in the use of interest rates as a policy in Uganda and Nigeria.

In Uganda, interest rates have been frequently adjusted upwards or downwards depending on the economic environment. A major feature of the interest rate structure in Uganda is that since 1984 nominal interst rates for commercial loans have ranged from 24 to 42 percent, while deposit rates have ranged from 5 to 10 percent on demand deposits to a maximum of 35 percent on one-year time deposits.

In Nigeria, the interest rate policy aimed at reducing inflation, promoting savings, improving the allocation of resources and improving financial intermediation. According to the paper, the structure of interest rates in Nigeria gave preference to some priority sectors. Thus, in 1988 the lending rate ranged between 19 and 19.25 percent with the preferred sectors getting the lowest rate. Deposit rates ranged from 12 to 16 percent. Overall, the study concludes that in Nigeria, differential interest rates have actually been applied.

A.2.3. Differential Interest Rates in the Context of AAF-SAP

In the context of AAF-SAP, the paper argues that there is a case to apply differential interest rates due to a number of factors, including market failure, economies of scale, as well as political and social considerations. However, the paper emphasises that the selection of priority sectors and activities for preferential interest rates must be specific. These sectors could also vary from period to period.

Section B - Paper by Prof. Jorge Marshall, University of Chile

B.1. Multiple Exchange Rates (MER's)

B.1.1. Theoretical Basis for MER's

The major theoretical grounds in this report for the use of MER's are three - serious balance of payments deficits associated with the use of a single exchange rate; the existence of different groups of exports and imports facing different elasticities of demand and supply; and the possibility of separating foreign exchange markets by types of international transactions. The theoretical analysis is then presented in sub-sections as follows:

(a) Types of MER's - These MER's are for groups of exports and imports and consist of:

(i) Margin between buying and selling exchange rates or exchange spread

This MER can be fixed or created through taxes on foreign exchange (forex) transactions. The effects are the same as those of a uniform ad valorem tax on exports and imports.

External effects - The exchange rate margin causes great reduction in trade if the elasticities of demand for exports and imports are high, and the burden on exports is higher if the elasticity of supply of exports is less than the elasticity of demand for imports. But if the elasticities of demand for exports and imports are small, the volume of trade remains the same. Again, if the world offer curve is elastic, exchange spread improves the terms of trade, while for infinitely elastic world offer curve (the case for small countries), the terms of trade remains constant and trade declines. In the intermediate case of inelastic world offer curve, the terms of trade improves and the country gets more import for less export. The effect of exchange spread on the balance of payments is the same as that of a devaluation, and the implicit tax burden is shared between exporters and importers.

Internal Effects. The dominant internal effect of an exchange spread policy is to induce a shift of inputs from export industries to activities producing import substitutes. If domestic factor mobility is limited, this results in unemployment and lower real income.

(ii) Penalty rate for some exports - this MER is an export tax and it arises when the average exchange rate on such exports is less than the overall equilibrium exchange rate. It is used for increasing foreign exchange revenue, taxing some exporters and redistributing income. This policy is good for dealing with the 'Dutch disease' where there is differential performance between sectors (e.g. oil and agriculture) such that a single equilibrium exchange rate is harmful for the development of less efficient export activities, and induces a larger volume of cheap imports at the expense of local production. This means that the overall effects of this policy are less than those of exchange spread.

(iii) Subsidy for some exports - here the exchange rate for such exports exceeds the equilibrium exchange rate. Then the forex proceeds of some exports are sold at higher prices in local currency than the equilibrium exchange rate. This means lower production costs for such export activities. The effect is to change the composition of exports, but domestic inflation may hurt the subsidised exports. But if the demand for such exports is falling, the subsidy compensates for the lower foreign prices, so the policy is appropriate. Export penalty and subsidy may be combined over time to moderate the impact of cycles in world trade and stabilise exporters' income.

(iv) Subsidy for some imports - this makes the exchange rate applicable to such imports less than the equilibrium rate. It is used for (i) imports of essential consumer goods to raise real wages and redistribute income, but it benefits both poor and rich, and may discourage the domestic production of import substitutes; (ii) imported capital goods and raw materials for development. This requires the rationing of forex and the control of the prices of the products of the industries using such subsidised inputs; (iii) government imports in order to reduce expenditure - hence it should be financed by taxes on some exports and imports, or through monetary expansion if it is financed by the Central Bank at a loss. The effects of this policy on the terms of trade and balance of payments are opposite to those of an increase in import duties, but they are smaller.

(v) Penalty rate for some imports - this MER causes the exchange rate for such imports to exceed the equilibrium rate. It is typically aimed at protecting infant industries by shutting out their cheaper import competitors. Hence its effects are similar to those of an ad valorem tariff for financing the domestic production of substitutes for some imports or exports.

(vi) Dual foreign exchange market (official and non-official) - this is good for controlling undesirable, erratic and large international capital movements. To control such erratic capital movements, the IMF's Articles of Agreement sanction the use of this policy. The problem arises when the policy has achieved the convergence of the two market rates and is retained. Then it causes over/under-invoicing and smuggling. It thus works well when the free (non-official) market rate is not erratic and the spread between the two rates is small. But this dual rate system cannot be used for the repatriation of flight capital because this responds to other strong economic and non-economic factors.

(b) Other Related Policies to MER's

These are advance import deposit and other forms of international payments designed to reduce imports such as:

(i) Advance import deposit - this is the same as exchange spread if it is large and sustained. It is a multiple exchange rate, or a monetary policy for increasing or contracting the monetary base for credit creation. The effect is once and for all unless it is changed. In Latin America, its objective has been to reduce the level, or change the structure, of imports so that it is an alternative to devaluation or MER. Its disadvantages are that it constitutes a free loan by importers to financial institutions and it is inappropriate for capital and invisible transactions.

(ii) Payment conditions - these are for restricting some imports, rationing forex and giving priority to essential imports. It is thus used for barter or bilateral trade agreements and partial or full devaluation. Examples include delayed forex cover for some imports; five to eight year credit for 80% of the value of imported capital goods; and advance payment by foreigners for exports of strategic products. They are all temporary measures, but the IMF regards payment arrears as MER.

(c) Relations Between MER's and Trade - Fiscal Policies

MER's, trade and fiscal policies are related and they have trade-offs.

(i) Trade policies - many trade policies like taxes and subsidies on trade are like MER's but they have significant institutional differences. These are that trade policies apply to commodity trade only; multiple rates are more flexible but they also fall under IMF surveillance; MER's are administrative measures that usually require no legislation and they are less visible to the public; the profits on MER's go to the Central Bank while revenue from trade policies accrue directly to government. Hence both MER's and trade policies are often used to supplement each other.

(ii) Fiscal policies - MER's have fiscal effects, e.g. they generate net revenue or losses. One other relation between them is that exchange spread is allowed by the IMF to mop up large fiscal deficits. Export tax is thus both for raising revenue for government and increasing forex revenue permanently - as is the case with import tax on luxury goods. Thus MER's are like indirect taxes in their fiscal effects.

(d) MER's and Economic - Financial Integration

In developing countries, MER's can hamper financial integration, though for foreign trade and industrial cooperation, they pose no problems. Under a clearing arrangement, multiple rates (MR's) require that foreign transactions should be in an agreed accounting unit, e.g., US dollars, though free exchange rates for some transactions may be problematic.

(e) MER's and IMF Reactions Over Last Three Decades

MER's have evolved over the last three decades but IMF rules prohibit them. It is only if they are simple and temporary that they are tolerated. The Fund's Board reviewed them in 1984 and 1985 and found that few countries have multiple currency practices on capital accounts. They were many in the 1950s, simplified in 1960s and increased in late 1960s and early 1980s as alternative to devaluation, for controlling capital outflows and for debt service. The Fund's arguments against them are that they are: (a) likely to become permanent, (b) not effective for their stated goals, (c) unstable and (d) costly and inefficient for resource allocation. But the Fund's overall decision is that they can be tolerated if they are flexible, pragmatic and temporary - yet the Fund is not flexible in its attitude to them in practice.

B.1.2. Empirical Cases of MER's in Latin America

(i) Argentina has been pushed into the use of MR's by war, crises and severe inflation. In 1960, it adopted advance import deposit on capital equipment with surcharges, and by 1987, it had a dual exchange rate system. The official rate was for trade, capital and public transactions with forex auction. These also included selective import taxes (5 to 22%), payments conditions with 180-day financing for most imports; special terms for capital imports and export taxes.

(ii) Brazil - to avoid devaluation in the post-war, it used mild inflation and complex MER's for development. In 1959 it had a dual exchange rate with forex auction for two export groups and exchange spread - these were abolished in 1961. In 1968, it had a free exchange rate with small adjustments within its 1965/72 Agreement with the Fund to simplify and liberalise the exchange rate. This was deflationary and it had to borrow heavily till 1982. By 1988, it adopted an import approval scheme, quantitative restriction on invisible payments and preferential exchange rates for financing exports.

(iii) Chile adopted a dual exchange rate after the Great Depression and during 1948/50, had export and import exchange rates. By 1955, its MR's failed and it had an IMF Agreement that abolished MER's and trade restrictions. Its exchange rate has been basically free since then with changes like pegging the rate (1970/82), quantitative restrictions and advance import deposit in the 1970s. After 1975, market rates were unified and import surcharges stopped. Then by December 1987, it imposed conditions on capital inflow and profit repatriation.

(iv) Paraguay started MER's around 1955 but by 1958 it approached the Fund and adopted a single floating rate with advance import deposit and export taxes by 1960. Between 1959 and 1979, it stabilised its exchange rate. But by 1985 ending, it had four exchange rates with three fixed by the Central Bank and the fourth free. It also had taxes on forex transactions so that there were different effective exchange rates.

(v) Uruguay started the post-war with complex MER's with the most favourable for 'wool tops' for invading the European market. By 1961 it adopted a flexible rate with a free forex market for capital and invisible transactions, import taxes and import surcharges for three out of four import groups. High inflation in later decades forced exchange changes. With a Central Bank established in the 1970s, it issued a new peso in 1987 with a free exchange rate by market forces, exchange spread, small tax on forex sale and payments conditions, involving small restrictions on exports and imports for revenue purposes that corresponded to old MER's.

B.1.3. MER's and AAF-SAP

(i) Conditions for Appropriate Exchange Rate

There is no unique answer to this question as different systems may serve a country. All are good if well managed with the right policies. The ideal is that the exchange rate system should be as simple as possible with minimum adjustments. A fixed rate system is like the gold standard, and their disadvantages are similar - the direct transmission of external disturbances to the domestic economy via fluctuations in export earnings, government revenue and money supply, especially as developing countries have no effective monetary means of off-setting capital movements. But a floating rate involves greater instability, jeopardises inflationary control and induces greater devaluation in the medium-term.

The prescription is, therefore, a managed exchange rate system that is not cumbersome, e.g., a single rate or a single official rate with a parallel free rate for capital and invisible transactions. The managed exchange system should be kept constant in real terms by adjusting nominal values in costs and prices at home and abroad by using the currency of the largest trading partner.

(ii) Types of MER's for Meeting Objectives of AAF-SAP

These MER's correspond to the six types discussed above. The dual market system is best for controlling capital movements and uncontrollable invisibles. Huge devaluation is bad and prohibition may encourage a parallel (black) market. It should be stated here that there is no clear-cut dichotomy between capital and current accounts as they are interrelated.

The other types of MER's can be used for temporary purposes along the lines suggested earlier.

(iii) Limitations on Use of MER's

These limits to the use of MER's are twofold:

(a) IMF opposition - this should be evaluated collectively or individually by African countries;

(b) Effective administration - competent and honest officials that can enforce the necessary controls are required.

B.2. Differential Interest Rate Policy (DIRP)

B.2.1. Theoretical Basis of DIRP

(i) Real and Financial Determinants of Interest Rates Under Capitalism - There are different interest rates with respect to type of debtors, loan maturity, risk, grace periods and forms of payment of principal and interest - hence the term structure of interest rates. The real determinants of interest rates are time preference of consumers and the productivity of capital and new investments. The financial determinants are Central Bank monetary policy.

There is no theoretical foundation for the determination of interest rates, and free market determination may be high or low, and yield positive or negative real interest rates as illustrated by the US and Chile under changes in the rate of inflation. Whether freely determined or fixed, the needs of development policy imply that the determination of interest rates by market forces is inadequate.

(b) Selective Credit Control - this is used for the control of inflation and as development policy. As development policy, it shifts funds from low to high investment priority. Hence credit control is for equalising private and social profitability as a tax-subsidy scheme, and realising the externalities of high priority sectors. Thus selective credit control (scc) is sanctioned by an IMF study because of reasons of distribution, employment and structural changes that are missed by the impact of aggregative monetary policy. But fiscal policy is better for promoting development - monetary and credit policies are secondary.

The limits to scc are that it may raise interest rates too high, worsen inflation, creat parallel credit markets and reduce bank profits.

B.2.2. Empirical Evidence on DIRP and SCC in Latin America

(i) Mexico uses SCC in two ways, namely, by establishing special banks and using selective credit orientation. This latter is through credit guidelines and compulsory bank reserves like the Financial Development Fiduciary Funds, or through the use of second-floor banks for agriculture, manufactured exports, industrial equipment, small-medium scale industries, education credit, tourism and housing.

(ii) Ecuador - SCC is used through the creation of specialised banks for development, finance, fund for development of rural marginal sector, industry and housing.

(iii) Chile uses specialised public institutions and Central Bank guidelines for SCC, e.g., Mortgage and Savings Banks, specialised institutions for financing industry, agriculture and mining like the Production Development Corporation. Central Bank credit rules include the discounting of production bills, reserve regulations, 'cash flow budget line' from 1960s to 1973 and positive real cost of credit to users. By 1975, interest rates were freed and this was followed by financial collapse. Since then, the Central Bank has not been borrowing or lending, except short-term credit for price stability - but this is dogmatic and wrong.

B.2.3. DIRP and AAF-SAP

The use of DIRP for the achievement of the objectives of AAF-SAP involves two considerations.

(a) Specialised institutions - these are similar to the IMF, World, IDA, etc. under the Bretton Woods system which worked till the mid-1960s. Hence African countries can also use similar institutions effectively for the application of DIRP.

(b Interest rates in AAF-SAP - Fixed rates may be negative, especially on bank deposits and this may weaken financial intermediation, which is detrimental to development. Low real rates of interest are also inefficient for production, encourage excessive demand for credit and worsen balance of payments deficit due to the transfer of savings abroad.

But market interest rates are inappropriate in developing countries because their financial markets are too narrow and easily manipulated; changing rates of inflation cause prices to move unevenly so that adjusting interest rates to prices produces uneven effects; with foreign debts, interest rates affect production costs and high rates force government to make unnecessary debt concessions.

The combination of fixed but adjustable (crawling peg) and free interest rates is better. The fixed rates should be few in number and for limited uses.

The risks of free-active rates, however, are that they may be too high and cause too wide margin between the passive and active rates, which makes financial intermediation improfitable. The alternative to free interest rates could also be the creation of private liabilities with specified maturities.

Section C - Paper by Pascal Salin, University of Paris, Dauphine

Multiple Exchange Rates (MER's)

The paper discusses MER's with respect to balance of payments analysis and taxation. It discusses their operations in both the long-run and short-run.

C.1. Basic propositions about the Balance of Payments

Theoretical Basis

Balance of payments analysis is an application of the general theory of exchange which starts with the two sides to every transaction - purchase and sale. Hence modifications to the import part of the balance of payments (BOP) has implications for the export side. So policies for eliminating BOP deficit affect relative time preferences as well as both imports and exports. Such adjustment policies cannot succeed unless they correctly deal with the causes of payments disequilibrium.

C.1.1 Basic propositions about protection

Protective policies such as MER's, devaluation, tariffs and subsidies, price controls and taxes typically affect the structure of the BOP, internal relative prices, nominal (absolute) prices and government revenue. This is why an import tariff together with an equivalent export subsidy is equivalent to a devaluation in terms of its effects on nominal prices - with differences in administrative cost and the equilibrium value of the nominal exchange rate. If we assume that the protectionist country is large in world trade, it can shift some of the effects of its protectionist policies onto the outside world - in a way that a small country cannot (because it is a price-taker).

C.2 Long-run Working of MER's

MER regimes generate effects on relative prices that are similar to those of protectionist policies like tariffs and subsidies.

C.2.1. Classification of MER's

MER's are strictly infinite since a transaction can be isolated for a specific exchange rate. Different exchange rates can thus be applied to trade and capital transactions, exports and imports, raw materials, etc. With any of these rates being fixed or flexible. The two dominant sets of MER regimes are those that (a) separate commodity and asset transactions (b) differentiate commodities.

The evaluation of the operation of multiple rates (MR's) involves the following considerations:

- changes in different relative prices between different commodities, internal and external transactions, present and future goods;

- other available policy instruments that can or are being used;

- availability of data on ultimate impact of MR's;

- how effectively MR's can be enforced.

C.3. Dual Exchange Rates for Commodities and Assets

In this MER regime, there is usually a fixed rate for commodity trade and a floating rate for asset transactions, or even two different fixed rates as well as other varieties. Flexible rates are used for assets because capital flows are more volatile than trade flows, while the fixed or commercial rate for commodities is assumed to correspond to the long-run equilibrium rate. There are three common dual exchange rates:

C.3.1. Uniform dual rates for capital movements and returns

This system perfects the separation of the commodity and assets market. The trade deficits there can arise from excessive money supply or sale of assets (which creates a surplus on the capital account of the BOP). But with the complete separation of the two markets, it becomes impossible to have a trade deficit or surplus, or to trade present against future goods. This system also discourages investment capital import and undermines the financial rate for assets. It makes it impossible to exchange an asset or its returns for commodities on the international market. Hence this dual exchange system cannot be recommended.

C.3.2. Different exchange rates for repatriation of investment and returns

The usual case here involves the use of a commercial exchange rate (for goods) for the repatriation of returns on investment, and a financial rate (fixed or floating) for capital inflows or outflows, and vice versa. In either case, there is a positive or negative taxation of capital flows - an undervalued currency for capital outflows is equivalent to a tax on capital outflows, and so is an overvalued currency for the repatriation of investment returns. Similarly, an overvalued currency for capital inflows is equivalent to a subsidy on capital inflows, and so is an undervalued currency for their returns. There is, therefore, a choice between dual exchange regimes and tax reform. Thus a dual rate may be preferred to exchange control in a country facing potential capital outflow because of reduced taxation of capital income abroad, while the country does not want to reduce its own tax on capital income.

C.3.3. Asymmetrical dual rates

This involves the use of a commercial rate for goods and a different special financial rate for only capital inflows or outflows (not both as in (i) and (ii) above). This is similar to the case of a special tax on investments/returns in the domestic country.

C.3.4. Practical problems with dual rates

(i) Limited information on the precise causes of a balance of payments problems and the possible effects of a dual exchange rate system. When dual rates are used by different countries in a generalised way, the changes in relative prices become complex - as in generalised protection.

(ii) Administrative costs of the dual rates may be very high

(iii) Leakages may occur as controls cannot be perfect and this may jeopardise the realisation of the desired results.

C.4. Different exchange rates for different commodities

Under this MER regime, different rates apply to different exports and imports - and the rates for financial transactions may have to be decided. The analysis is then similar to that of protectionism. Thus different rates for exports and imports produce effects similar to those of tariffs and subsidies - with relative price effect, unchanged time preferences and no effect on the trade balance. If there are different rates for some commodities only, there is a protection effect. In this case, MR's are temporary measures to offset undesirable effects in a stabilisation plan, so that explicit taxes and subsidies are possible alternatives to MR's.

C.5. MR's as short-run adjustment policy

These arise in two ways in a stabilisation plan:

(i) MR's can be used as alternative instruments to modify the BOP. But as shown above, MER regimes may or may not affect the structure of the BOP;

(ii) stabilisation programmes should not aim at BOP adjustment but at macroeconomic adjustment. This is because the apparent disequilibrium in the BOP is the consequence of imbalance between aggregate demand and supply - to which stabilisation should apply. So if MER's are seen only as ways of adjusting the BOP, then they will be able to remove the causes of the so-called BOP problem.

For example, there may be 'overshooting' in a unitary floating rate regime due to restrictive monetary policy, which causes the exchange rate to appreciate too high as interest rates adjust more rapidly than commodity prices to the change in monetary policy. In this case, a dual exchange regime, with different rates for commercial and financial transactions, can serve to isolate the domestic rate of interest and the foreign rate.

Section D - Paper by JEFAD on Production Subsidy and Food Self-Sufficiency in Africa

This report examines the critical role that production subsidies can play in enabling the African continent to attain self-sustaining growth and development, which can only come from the transformation of the continent's economic and social structures. The continent's production problem is first and foremost one of the transformation of the structures of production with due regard to what is produced and how it is produced. In this regard, the current African economic crisis is a clear validation of Africa's stated strategy of attaining regional food self-sufficiency, and the need to focus on the production of all of the continent's critical needs and services.

It is interesting to note, however, that most of the reform measures currently being imposed on African economies continue to call for an important role for international trade, mainly with the developed market economies to meet the food needs of Africa. The fact that many food-surplus developed economies of the world fully appreciate the need for managing their own food economies, and have been using subsidies to create abundant supplies and lowered the prices of food items which are then dumped into African markets thus creating considerable externalities for African agricultural producers, clearly suggests that agricultural administrators and policy makers alike in Africa should review their position. This is with regard to the conflicting goals of ensuring adequate food supplies for their population at reasonable costs, mainly through developing food self-sufficiency capabilities and supplemented with imports.

The achievement of the above goal will require the intervention of African governments at the level of food production, marketing, consumption, and trade. Well designed and well targeted incentive schemes to stimulate and generate the needed increased agricultural production in Africa will need to be put in place.

Despite the numerous criticisms currently levelled against them, production subsidies continue to provide one of the most effective tools for attaining the food self-sufficiency goal in Africa. The purpose of this report, therefore, is to examine the role that agricultural production subsidies can play in the goal of attaining food self-sufficiency in Africa.

The report examines the purpose of different types of agricultural production subsidies and outlines the contemporary theory of production subsidies. The major traditional purpose of production subsidies in Africa has involved agricultural inputs. The report therefore attempts to provide selected case studies involving the application of input subsidies in Africa and examines the issue of subsidies in the context of the Economic Commission for Africa's African Alternative Framework to Structural Adjustment Programmes (AAF-SAP).

The report concludes that, while there are several policy tools which a government can use to increase the availability of designated products, such as tariffs or quantitative restrictions on imports, domestic content requirements as a condition of domestic production, and even trade liberalization, if the attainment of food self-sufficiency by increased production of designated food products is the objective of government, a subsidy on the production of these commodities will represent the most economically efficient manner to achieve the objective.

PART II: SUMMARY OF ISSUES TO FOCUS ON

From the summaries of the three papers presented in Part I and taking into account the need to clearly identify the issues that African policy makers need to focus on, the present part identifies some of the most crucial issues that the experts should consider and make recommendations upon. These issues are grouped under the three categories of SAF-SAP policy instruments that have been studied, namely, (a) multiple exchange rates, (b) differential interest rates and (c) production subsidies.

1. MULTIPLE EXCHANGE RATE SYSTEMS

A. Theoretical Approaches

(a) What is the theoretical basis for Multiple Exchange Rates System (MERS)?

(b) What approaches to Multiple Exchange Rates System can be devised, and in the light of experience what lessons can be learnt?

(c) What trade-offs and necessary relations exist between Multiple Exchange Rates Systems and other policy instruments, especially trade and fiscal policies?

B. Empirical Evidence

Experiences of selected countries (African and non-African) in the application of Multiple Exchange Rates Systems, in particular:

i) under what conditions were MER'S applied and under which conditions they were adopted and applied;

ii) identification and evaluation of benefits and costs (domestic and external) arising from the application of MER'S;

iii) assessment of the factors influencing the actual implementation of MER'S - administrative and institutional.

C. Multiple Exchange Rate Systems in the Context of SAF-SAP

i) Objectives for which MER'S should be designed;

ii) Conditions under which application of MER'S is desirable and viable;

iii) Methodology, mechanisms and time frame to be established in the implementation of Multiple Exchange Rate Systems;

iv) Anticipated trade-offs and complementarity between MER'S and other policies;

v) Mechanisms for continuous monitoring and implementation of MER'S.

2. DIFFERENTIAL INTEREST RATE POLICY (DIRP)

A. Theoretical considerations of Differential Interest Rate Policy (DIRP) in the context of overall macro-economic policy and selective credit policy:

i) Market mechanism;

ii) Development priorities;

iii) Trade-offs and relationships with other policy instruments.

B. Empirical Evidence

Experiences of selected countries in the application of DIRP and in particular:

i) under what conditions was DIRP applied and under which conditions it was adopted and applied;

ii) identification and evaluation of benefits and costs (domestic and external) arising from the application of DIRP;

iii) assessment of the factors influencing the actual implementation of DIRP: administrative, and institutional.

C DIRP Application in the context of AAF-SAP:

i) Objectives for which DIRP should be designed;

ii) Conditions under which DIRP is desirable and viable;

iii) Methodology, mechanisms and time-frame to be established in the implementation of DIRP;

iv) Anticipated trade-offs and complementarity between DIRP and other policies; and

v) Mechanism for continuous monitoring and implementation of DIRP.

3. PRODUCTION SUBSIDY AND FOOD SELF-SUFFICIENCY IN AFRICA

(a) Is there a strong theoretical basis for the use of production subsidies in agriculture?

(b) What credence can be given to the arguments that developing countries cannot subsidise their production and exports since the latter are inelastic and the countries are price-takers?

(c) What basis should be used to determine an efficient targetting of subsidies and their phasing?

(d) What are the structural, institutional and administrative condition needed for an efficient subsidy policy.

(e) What role should subsidies play in the efforts to attain the goal of food self-sufficiency in Africa.